

Lifting the resource curse by using local content requirements

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Table of contents

ABBREVIATIONS	III
1 INTRODUCTION.....	1
1.1 Definition and International Background	1
1.2 Relation to Brazil's obligations under the GATT/WTO	4
1.3 Local Content in Brazil	6
1.4 Narrowing of the scope	7
2 BASIS FOR THE LOCAL CONTENT REQUIREMENT IN THE OIL UPSTREAM INDUSTRY IN BRAZIL.....	9
2.1 Natural resources and the sovereignty of coastal states	9
2.2 The Petroleum Legal and Regulatory Framework	10
2.2.1 Legal background	10
2.2.2 The Oil Act	12
2.2.3 Government procurement	13
3 LOCAL CONTENT RULES AND THE RELATION WITH COMPETENT BODIES BEHIND THEM.....	21
3.1 Petróleo Brasileiro S.A. - Petrobras and the role of national oil companies (NOCs) in the implementation of local content	21
3.2 Conselho Nacional de Política Energética	22
3.3 Agência Nacional do Petróleo, Gás Natural e Biocombustíveis.....	23
3.4 The Local Content policy	24
3.5 Programa de Mobilização da Indústria do Petróleo e Gás Natural	28
4 THE NORWEGIAN SYSTEM AND SIMILARITIES.....	29
4.1 The upstream regulatory framework	29
4.2 The Local Content requirements	29
4.3 NPD	33
4.4 Statoil	33
5 CONCLUSION.....	35
TABLE OF REFERENCE	39

Abbreviations

ANP: Agência Nacional de Petróleo e Gas Natural

BNDES Banco Nacional de Desenvolvimento Econômico e Social

CNPE: Conselho Nacional de Política Energética

GATT: General Agreement on Tariffs and Trade

GPA: Agreement on Government Procurement

LC: Local Content

NPD: Norwegian Petroleum Directorate

ONIP: Organização Nacional da Indústria do Petróleo

PETROBRAS: Petróleo Brasileiro S.A. (Brazilian National Oil Company)

PDP: Productive Development Policies

PRONIMP: Programa de Mobilização da Indústria do Petróleo e Gás Natural

TRIMS: Agreement on Trade-Related Measures

UNCLOS: United Nations Convention on the Law of the Sea

WTO: World Trade Organization

1 Introduction

1.1 Definition and International Background

The local content requirement (LC) represents a commitment of foreign companies who wish to pursue activities in a certain country to purchase a stipulated percentage of goods and services of local suppliers. Its main objective is to stimulate the creation and development of the local industry, enlarge the technological development, improve the education and training of local professionals and, by doing this, raising tax revenues and creating more direct and indirect job opportunities. It may be applied in different industries, depending on which parts of the country's economy needs this protectionism measure.

Many developed countries used such mechanism as well as export performance mechanisms in their industries in the past. As examples, there is Canada in its automobiles industry, Australia in the automobiles and tobacco industries, and other European countries in the automobilist and electronics fields.¹ The UK adopted such policy with focus on in-country procurement, while Norway adopted the LC rule in article 54 of the Royal Decree of 1972, focusing on indigenous participation. Before that, LC rules were also applied in Norway in concession agreements and also in the field of natural resources, in the Act of acquisition of waterfalls of 1917².

The LC as a policy in the oil and gas industry is said to have been originated in the North Sea early in the 1970s and took the form of import restrictions and creation of national oil companies.³

LC requirements were also applied in Norway, as pointed out by Nordås, Vatne and Heum⁴:

Norway has never made specific requirements as to the share of local content. Norway, however, stated that Norwegian based firms should be chosen when they are competitive in price, quality and delivery. Nevertheless, the oil companies never doubted that the Norwegian government and politicians appreciated the choice of local firms to apply the oil and gas activities with goods and services, and they were pretty sure that this would be honored in negotiations for future licenses.

1 Veloso, Francisco M. *Undersanding Local Content Decisions: Economic Analysis and an Application to the Automotive Industry*. Journal of Regional Science, vol. 46, no.4, 2006, pp. 747–772.

2 Act nr. 16, chapter I (2), 4.

3 Tordo, Silvana. *National Oil Companies and value creation*/ Silvana Tordo with Brandon S. Tracy and Noora Arfaa. World Bank Working Paper no. 218, 2011, pp. 09.

4 Nordås, Hildegunn Kyvik; Vatne, Eirik ; Heum, Per. *The upstream petroleum industry and local industrial development: a comparative study*, Institute for Research in Economics and Business Administration, Bergen: SNF Report No. 08/2003, pp. 65.

Thus, during the late 1970s and early 1980s local firms probably were chosen even if they were not the most cost effective.

However, stating that Norway has never made specific requirements when concerning LC is not exactly correct, considering that among other measures, concession agreements provided that at least 50% of the total expenditures of R&D covered by the licenses would be spent in Norway and in cooperation with Norwegian contractors⁵, requirement adopted to help develop the Norwegian industry, as we will see in a future topic.

In the 1980s, however, governments that had made use of such productive development policies – PDPs⁶ – started to change their way of thinking. This change was “reinforced by a push for more trade liberalization, with the Uruguay Round and the creation of the World Trade Organization (WTO), and by the need to implement market reforms in developing countries that were facing a debt crisis.”⁷

The governments of Margaret Thatcher and Ronald Reagan in the 1980s, respectively in the United Kingdom and in the United States of America, were decisive for the international politics, which also affected the oil industry. The transition of many years of social democracy in Norway to a Conservative Government in 1981, with Kåre Willoch as the Prime Minister, followed the international tendency. However, this did not affect the protectionist measures existent on the Norwegian oil sector. The process of weakening of the protectionist regime started at the end of the decade, due to external conditions such as the creation of the internal market of the EU and to the fact that the Norwegian oil industry was capable of walking alone.⁸ Thus, the industry was considered developed enough to ‘survive’ without protectionist measures.

However, many resource rich developing countries still make use of such measure in the natural resource industry in general and the oil and gas sector in particular. Considering this, it is relevant to mention the resource curse theory⁹. According to it, an increase in mineral resource revenues may “impede economic development of a country, trigger political instability, increase social inequality and hamper smooth democratic processes”.¹⁰

However, it has also been proved that this curse is not an ‘iron law’¹¹. It can be avoided if the resource rich developing countries governments adopt policies and strategies in

5 Cf. Agreement on Technological Research and Development attached to the concession agreement for the 12th round of bid, held in 1988, clause 3.1.

6 Term adopted by Tordo, Silvana, Michael Warner, Osmel E. Manzano, and Yahya Anouti. in *Local Content Policies in the Oil and Gas Sector*. World Bank Study. Washington, DC, 2013.

7 Tordo, Silvana. *National Oil Companies and value creation*/ Silvana Tordo with Brandon S. Tracy and Noora Arfaa. World Bank Working Paper no. 218, 2011, pp. 18.

8 Ryggvik, Helge. *Building a Skilled National Offshore Oil Industry – The Norwegian Experience*. NHO, Avdeling for internasjonalisering og europapolitikk, 2013. 1st edition. Pp. 89.

9 Ross, Michael. *The Political Economy of the Resource Curse*. World Politics, Vol. 51, No. 2, January 1999, pp. 297-322.

10 Ado, Rabiu. *Local Content Policy and The WTO Rules of Trade-related Investment Measures (TRIMs): the Pros and Cons*. International Journal of Business and Management Studies. Aberdeen: Vol.2(1), 2013, pp.137

11 Auty, Richard M. *Industrial Policy Reform in Six Large Newly Industrializing Countries: The Resource Curse Thesis*. World Development. 1994, pp. 12.

order to extend the benefits of their extractive industry to other sectors of the economy. One of the most common measures used is the LC policy.¹² In other words, LC can be used to reduce the “resource curse”.

In developing countries, it is essential for local supply industries to be more competitive, because the better providence and maintenance of necessary infrastructure, the higher the level of social welfare. The LC provides benefits for the economy. For example, local employees will spend much of their wages on domestically produced goods, and thus create more jobs. Similarly, purchasing goods from a local supply company will require that this company buy inputs in order to produce its outputs, and again some of these indirect inputs will be domestically produced.¹³ LC policies are in essence a tradeoff between short-term efficiency and long-term economic development.¹⁴

Among the arguments in favor of this measure is the fact that the emerging domestic industries lack the economies of scale advantage, and thus need protection and support until they can effectively compete with more mature and developed international industries. There is also the argument on market power, according to which suppliers might purchase powers in order to make the local firms be at disadvantage. Another argument is the social compensation argument, taking into account that the oil exploration activity is an activity of high environment impact, which brings the idea that oil communities that have been affected negatively due to oil operations should get compensated. LC policies can also be used as an instrument to achieve several political objectives.¹⁵

On the opposite side, as arguments against the LC requirements, we have (i) the misallocation of resources and/or inefficiencies, which is basically the question on whether such policy actually is an efficient way in improving welfare; (ii) the misalignment between instruments and policy objectives, which is the idea that if a policy maker thinks that there is an externality, in other words, a side effect of an industrial or commercial activity that affects other parties without this being reflected in the cost of the goods or services involved, this should ensure that there is indeed an externality and that the instrument chosen corrects the externality, otherwise the measure loses its purpose. For example, if the labor force is not adequately trained to satisfy the requirements of the oil sector, the policy maker should first establish whether training would be sufficient or if the situation demands structural changes to the country’s educational system; (iii) the compliance with international regulations; and (iv) and, finally, institutional frameworks, since it is very likely that PDPs for sectors capture by

12 Ado, Rabiul. *Local Content Policy and The WTO Rules of Trade-related Investment Measures (TRIMs): the Pros and Cons*. International Journal of Business and Management Studies. Aberdeen: Vol.2(1), 2013, pp.138.

13 Tordo, Silvana, Michael Warner, Osmel E. Manzano, and Yahya Anouti. *Local Content Policies in the Oil and Gas Sector*. World Bank Study. Washington, DC, 2013.

14 Tordo, Silvana. *National Oil Companies and value creation/* Silvana Tordo with Brandon S. Tracy and Noora Arfaa. World Bank Working Paper no. 218, 2011, pp.9.

15 Ado, Rabiul. *Local Content Policy and The WTO Rules of Trade-related Investment Measures (TRIMs): the Pros and Cons*. International Journal of Business and Management Studies. Aberdeen: Vol.2(1), 2013, pp. 141.

lobbies, especially if they are market interventions. The beneficiary sectors will have no incentive to become more productive and will lobby government to maintain the benefits indefinitely.¹⁶

Considering this last argument, it is known that when multinational companies approach the local governments in order to obtain concessions or licenses for drilling, the lobby and negotiating process end up creating jobs for local professionals. Not only do the companies need to adapt to the local laws and rules, but they also need to learn how to operate in the state apparatus as well as in the political scenario of the country. In this kind of sphere, the oil industry has been frequently accused of being the source of influence of the public authorities.¹⁷

Without doubt, there are still many challenges in the application of the LC in developing countries, because of their economical characteristics as well as the project environment, which in the most cases have a lack of competent people and unrealistic LC expectations. However, there are still many reasons to defend the application of the LC as a policy.

Therefore, considering all the social and economic aspects displayed above, and how many offshore companies, including many Norwegian, are investing in the exploration of oil fields in Brazil, the scope of this paper is to analyze the legal aspects of the use of LC in the oil industry in Brazil. Although much of the material written concerning LC is analyzing it through an economical point of view, it is possible to see an increase in the legal studies concerning that topic.

During the writing of this thesis, I bear in mind that the readers do not have, or have a limited knowledge of the Brazilian legal system or even of what is LC. For this reason, this paper was written in a very descriptive way, when addressing not only the measure itself, but also the regulatory system and administrative bodies behind it.

1.2 Relation to Brazil's obligations under the GATT/WTO

Despite their widespread adoption and enormous impact, LC measures have not been properly categorized or comprehensively analyzed as to the WTO legality.¹⁸ It has been for many years a popular topic among economists, but there is less legal materials concerning the subject. Therefore, considering the focus of this paper on the legal aspects of LC, it is necessary to provide some insight on the legality of the use of this measure under the WTO.

Brazil has been a member of the General Agreement on Tariffs and Trade (GATT) since 30 July 1948. The replacement of GATT by the World Trade Organization (WTO) took

16 Tordo, Silvana, Michael Warner, Osmel E. Manzano, and Yahya Anouti. *Local Content Policies in the Oil and Gas Sector*. World Bank Study. Washington, DC, 2013, p. 26- 31.

17 Ryggvik, Helge. *Building a Skilled National Offshore Oil Industry – The Norwegian Experience*. NHO, Avdeling for internasjonalisering og europapolitikk, 2013. 1st edition. Pp. 19.

18 Hestermeyer, Holger P.; Nielsen, Laura. *The Legality of Local Content Measures under WTO Law*. *Jornal of World Trade*, volume 48, issue 3, 2014, pp. 555.

place in 1st January 1995, as a part of the Uruguay Round negotiations. Then, the GATT contracting parties, by signing the WTO agreements, which include the updated GATT, became officially known as WTO members. The original GATT text (GATT 1947) is still in effect under the WTO framework, subject to the modifications of GATT 1994.

Being a member of the WTO as well as the new GATT, Brazil is bound by its obligations. One of GATT's agreements is the Agreement on Trade Related Investment Measures (TRIMs), which creates several prohibitions concerning measures that limit freedom of trade. However, Brazil has not signed the Agreement on Government Procurement (GPA). Thus, the first question is whether the LC is applied in the context of government procurement.

The granting of permission for oil exploration in the Brazilian Continental Shelf is done through concession or production sharing agreements. These are precedent of bidding processes in which LC is one of the requirements for participation in the tender process. This measure later becomes a contractual obligations for the winning bidder.

Therefore, it is necessary to analyze the legality of the LC rule concerning the agreement on TRIMs, of which Brazil is one of the parties, and then, considering that Brazil is not a party to the GPA – what are the implications for the use of this measure.

The WTO agreements cover goods, services and intellectual property. Among its main objectives are: providing principles of liberalization and permitted exceptions; including individual countries' commitments to lower customs tariffs and other trade barriers, and to open and keep open services markets; setting procedures for settling disputes; prescribing special treatment for developing countries; and requiring governments to make their trade policies transparent by notifying the WTO about laws in force and measures adopted, and through regular reports by the secretariat on countries' trade policies.

The basis for the present WTO system are the Uruguay Round agreements, which, among other things, raised the issue of the TRIMs, resulting in the Agreement on TRIMs. This agreement stipulates in its article 2nd, that "[...] no member shall apply any TRIM that is inconsistent with the provisions of Article III or Article XI of GATT 1994."

Following this, it is stated in article III, paragraph four of GATT that products of foreign origin imported into the territory of any other country shall be accorded treatment no less favorable than that accorded to like products of national origin.

For this reason, through a first analysis of these agreements, it might look like LC requirements are incompatible with GATT, as also expressed in the most recent edition of the *Journal of World Trade*: "Local content measures most often violate at least one of the paragraphs of article III because by their very nature they condition a benefit on the use of goods of national origin and thus discriminate goods according to their territorial origin."¹⁹

19 Hestermeyer, Holger P.; Nielsen, Laura. *The Legality of Local Content Measures under WTO Law*. *Journal of World Trade*, volume 48, issue 3, 2014, pp. 566.

Although the TRIMs Agreement did not define prohibited TRIMs, it did provide an illustrative list which contained LC requirements, trade balancing requirements and export restrictions, in its Annex, paragraph 1. Among the items considered inconsistent with the TRIMs agreement is the mandatory purchase or use of products of domestic origin.

However, whilst GATT contains general obligations on national treatment, it excludes government procurement from these obligations.²⁰ Or in other words, there is a derogation²¹ from the national treatment obligation of article III. This can be expressly seen in article III.8 (a) of GATT: “The provisions of this Article shall not apply to laws, regulations or requirements governing the procurement by governmental agencies of products purchased for governmental purposes and not with a view to commercial resale or with a view to use in the production of goods for commercial sale.”

The content of this provision shall be thoroughly analyzed further on when discussing government procurement. But, in a brief analysis, in case governments have not signed the GPA, they remain free to discriminate in favor of national industry and to choose their own procurement procedures and policies, independent of consequences that this position might create for suppliers from other WTO members in participating in the government contracts.²²

There has been some doubt concerning the legality of the LC measures even in case the country has not signed the GPA agreement.²³ For this reason, we will come back to this subject in the topic concerning government procurement.

1.3 Local Content in Brazil

Taking into account that the LC rule is applied in the oil industry in Brazil, I will now present the purpose for the discussion of the LC rule on this paper.

Since the beginning of its application in the Brazilian oil industry in 1999, the LC requirement has raised many questions as to the lack of clarity of its rules and of the methodol-

20 World Trade Organization. *The WTO regime on government procurement: challenge and reform*. Edited by Sue Arrowsmith, Robert D. Anderson. 2011, pp. 06.

21 Expression used by the Appellate body in the case Canada – renewable energy, discussed in Hestermeyer, Holger P.; Nielsen, Laura. *The Legality of Local Content Measures under WTO Law*. *Journal of World Trade*, volume 48, issue 3, 2014, pp. 577.

22 World Trade Organization. *The WTO regime on government procurement: challenge and reform*. Edited by Sue Arrowsmith, Robert D. Anderson. 2011, pp. 07.

23 In the case Canada – Renewable Energy, the WTO’s highest court has confirmed that the local content requirement in the Canadian province of Ontario’s feed-in tariff (FIT) program for renewable energy is inconsistent with the derogation existent in article III (8) of the Agreement on TRIMs. The FIT program conditioned the participation of producers of renewable energy on the use of domestic goods and services in the development and construction of the facility producing energy. The government of Canada tried to justify this program arguing that it was a program governing the procurement of electricity by the government of Ontario. Among the arguments for the WTO decision was the fact that the product being subjects to the local content requirements was renewable energy generation equipment, which was purchased by the generators of electricity, while the product purchased by governmental agencies is electricity. This is decisive considering that paragraph 8(a) read in the context of the other paragraphs of article III of the Agreement on TRIMs requires the product procured and the product discriminated against to be in a competitive relationship. The implications of this decision may affect not only the field of renewable energy, but also other areas, considering how remote the content requirement can be in relation to the product procured. Source: Hestermeyer, Holger P.; Nielsen, Laura. *The Legality of Local Content Measures under WTO Law*. *Journal of World Trade*, volume 48, issue 3, 2014, pp. 577,578.; and reports of the Appellate body for the case Canada – renewable energy, available at: http://www.wto.org/english/tratop_e/dispu_e/412_426abr_e.pdf

ogy applied²⁴. This is still one of the most frequent complaints. There are also complaints by the big oil companies about the lack of capacity of the local industry to produce the certified products and services²⁵ and to qualify labor²⁶.

One of the scopes of this paper is to analyze the impact of the application of LC requirements in the oil industry in Brazil, taking into account these frequent complaints about the lack of clarity of the methodology applied for the quantification of LC, even after the use of the LC Booklet of ANP. In addition, I will go through the complexity of rules for the emission of the LC certificate; the lack of clear objectives for the inspection of the correct application of this measure; the characteristics of the LC clause and the penalties in case of non-compliance.

1.4 Narrowing of the scope

In order to make it easier to understand how the application of LC rules occurs in the Brazilian legal system, it is fundamental to first analyze the oil exploration regulatory framework. Then, I will explain the LC rules themselves, what are the competent bodies responsible for creating such rules and what are the measures for applying them in the system and for enforcing them.

First, it is relevant to mention that the activities of exploration of oil comprise the phases of identification of suitable areas to conduct the activities, which later shall be appraised, developed and produced.²⁷

The activities of exploration and production (E&P) are referred to as “upstream” oil and gas. The links between production and processing facilities as well as between processing and final costumer, including infrastructure, transport and storage, are usually referred to as the “midstream” activities. And, finally, the oil refining and gas processing turn the extracted hydrocarbons into usable products which are then distributed to whole sale, retail or direct industrial clients. These represent the “downstream” activities.²⁸

The focus on this work is the analysis of the LC requirements in investments done in the upstream industry – therefore, E&P activities.

In the second chapter, there will be an explanation of the historical legal background that lead to the current oil regulatory framework in the country. I will provide information concerning the rules around sovereignty of the coastal state over the natural resources in its territory, especially considering that most of the oil explored is located in offshore areas.

24 *O conteúdo local nos empreendimentos de petróleo e gás natural*. Sondagem PwC. Edited by PricewaterhouseCoopers Brasil Ltda. September 2012, pp. 05. Available at: <www.pwc.com.br>

25 Ibid, pp. 06.

26 Ibid, pp. 08.

27 Tordo, Silvana. *National Oil Companies and value creation*/ Silvana Tordo with Brandon S. Tracy and Noora Arfaa. World Bank Working Paper no. 218, 2011, pp.1.

28 Ibid.

Then, I will relate to the aspects of the regulatory framework for oil exploration in Brazil, which since 2010 has followed a hybrid model. This model comprises (i) Law n. 9478/97 - Oil Act, which opened the Brazilian oil market for foreign investments and created the basis for the application of the LC measure in the Brazilian oil industry; (ii) concession agreements, which are the contracts entered by the companies which win the tender after complying with the tender evaluation criteria; (iii) Law n. 12351/2010, the Pre-Salt Law, which regulates the oil exploration in the newly found Pre-Salt layer through production sharing system; and (iv) Production Sharing Agreements.

When addressing the concession agreements and production sharing agreements, I will first relate to government procurement, addressing the issue on the legality of LC measures under the WTO. Since one of the tender evaluation criteria as well as one of the clauses in the concession agreements and production sharing agreements demand a minimum percentage of LC, I will also address the matter of Brazil not having signed the GPA agreement and the implications.

In the third chapter, I will provide the specific rules on LC requirements in the Brazilian oil industry, by first providing information on the competent bodies behind these rules. First, I will relate to the Brazilian national oil company, its history, the legal background behind its functioning and the role in tender procedures and signing of concession and production sharing agreements and examine its relation to the application of the LC requirements.

In sequence, I will explore the importance of the National Petroleum Agency (ANP), which has similar functions as the Norwegian Petroleum Directorate (NPD), as the regulatory body for activities that integrate the oil, natural gas and biofuels industry in Brazil, created by the Oil Act in 1997.

After that, I will relate to the part played by CNPE, the National Energy Policy Council, also created by the Oil Act, explain its regulation and display its functions to the implementation of the LC requirements.

Further on, in connection with the roles played by these bodies, I will relate to the PRONIMP - Mobilization Program for the National Industry of Oil and Natural Gas, created in 2003 by the presidential decree n. 4925/2003, in order to encourage the participation of the national suppliers, in a competitive and sustainable way in the implementation of projects for oil and gas in Brazil and abroad. I will analyse how this project has been implemented so far and what results can be seen.

Finally, in the fourth chapter, I will relate to the Norwegian regulatory system and express the similarities and differences with the Brazilian system and how the country made use of the LC measure in the first decades of oil exploration.

2 Basis for the Local Content requirement in the oil upstream industry in Brazil

2.1 Natural resources and the sovereignty of coastal states

The Convention on the Territorial Sea and the Contiguous Zone done at Geneva on 29 April 1958 established on its article 2nd that the sovereignty of a coastal State extends to the air space over the territorial sea as well as to its bed and subsoil. This principle was embodied in the Brazilian Legal system with Decree n. 1098/70.²⁹ However, the Convention established that the continental shelf (CS) encompassed the bed and subsoil of the submarine areas adjacent to the coast, but outside of the territorial sea, up until the depth limit of 200 meters or up until the superjacent waters would allow the exploitation of natural resources. This criteria was considered redundant, since almost all maritime areas could be reached by the new technology to recover submarine resources. In that sense, there was the need for external limits delimitation.³⁰

In order to solve the problem, the United Nations Convention on the Law of the Sea (UNCLOS), which took place in 1992, provided that the CS of a coastal State comprises the seabed and subsoil of the submarine areas that extend beyond its territorial sea throughout the natural prolongation of its land territory to the outer edge of the continental margin, or to a distance of 200 nautical miles from the baselines from which the breadth of the territorial sea is measured where the outer edge of the continental margin does not extend up to that distance. In addition to this, article 76 also established that in case the CS margin exceeds 200 nautical miles, the maximum external limit would be of 350 nautical miles width.³¹

The coastal State has sovereign rights for the purpose of exploring CS and exploiting its resources. If the coastal state does not conduct said activities on the CS, no one may undertake these activities without express consent of the coastal State.

Brazil signed the UNCLOS in 10th of December 1982, and it was stated upon signature that it was ad referendum³², subject to ratification of the Convention in conformity with Brazilian constitutional procedures, which includes approval by the National Congress. It was approved through the Legislative Decree n. 5 of 9th November 1987, ratified in 22nd December 1988 and enacted by Decree 99.165 of 12th March 1990. It entered into force in the Brazilian legal system with the enactment of Decree 1.530 of 2nd June 1995.

29 Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014, pp. 63.

30 Ibid, pp. 70.

31 Brazil required the extension of its continental shelf to the UN because of a governmental program called Evaluation of Sustainable Potential of the Living Resources in the Exclusive Economic Zone, coordinated by the Inter-ministerial Committee for Sea Affairs, with the objective of identifying living sources and establishing the potential of their capture in the EEZ. The Plan of Survey of the Brazilian Continental Shelf was the program with the objective of determining the limit of the continental shelf. This program made it possible for Brazil to require the extension of its continental shelf to the United Nations. The strategic importance of the maritime area became known as “the blue amazon”, which added 4.500.000 km² to waters under Brazilian jurisdiction. Source: Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014,

32 Latin expression., which means ‘pending approval’.

Upon its ratification, the Brazilian Government stated, among other things, that, in accordance with article 310 of UNCLOS, the coastal State has, in the exclusive economic zone (EEZ)³³ and on the CS, the exclusive right to construct and to authorize and to regulate the construction, operation and use of all kinds of installations and structures, without exception, whatever their nature or purpose.

Finally, Decree n. 1098/70, which went into force in Brazil thanks to the Convention on the Territorial Sea and the Contiguous Zone, was repealed with the implementation of Law n. 8617/93, responsible for establishing rules about the Brazilian territorial sea, contiguous zone, EEZ and CS.

The deposits made in the State territory are considered as its ownership (vested in the State), where it exercises sovereignty and full jurisdiction, while in the CS it exercises it only by the means of exploring and exploiting oil.³⁴ Therefore the concessionaire may have the ownership of the oil explored, but not of the oil still in the deposits. This shall be discussed more thoroughly in the next topic.

2.2 The Petroleum Legal and Regulatory Framework

2.2.1 Legal background

Before 1997, oil exploration related activities in Brazil were regulated through the Oil Legislation, which was actually a set of different legal acts. In 1953, followed by an extense public campaign which made it clear that oil and natural gas were property of the state³⁵, Law n. 2004/53 created the legal basis for oil and gas exploration in Brazil. This Law established the State Oil Monopoly to all activities involved in the exploration and production of oil, denying the access of foreign capital to Petrobras. Therefore, during many years, Brazil was in a position of clear absence in the international scenario.³⁶

In 1988, with the adoption of the new Constitution, it reinforced in its article 177 (1) that the monopoly of the exploration of oil, natural gas and other fluid hydrocarbons belonged to the State.³⁷ It expressly stated that it was forbidden for the Union to transfer or grant any type of participation in the exploration of oil or natural gas deposits, unless such participation was done by states, municipalities or the federal district, according to article 20 (1) of the Constitution.

33 According to article 57 of the UNCLOS, the exclusive economic zone shall not extend beyond 200 nautical miles from the baselines from which the breadth of the territorial sea is measured.

34 Higgins, Rosalynn. *International Law and the Advance Containment and Resolution Disputes*. Recueil de Cours. Academie de Droit International de La Haya, Leiden, Netherlands, v.230, 1991, pp. 186.

35 The slogan of the campaign was “The Petroleum is Ours”, associated with the image of Petróleo Brasileiro S.A. – PETROBRAS, company created in 1953 to perform the activities related to the monopoly.

36 Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014, pp. 389, 390.

37 Ibid, pp. 405.

The circumstances surrounding oil exploration in the country suffered deep alterations with the constitutional amendment n. 9 of 1995, which made a radical change on the Brazilian legal system concerning these activities. It took from Petrobras the condition of monopoly executor and admitted the granting of concessions also to private companies, which was to be regulated through special rules.

Article 177 (1) of the Constitution was edited, providing that the Union can contract with state or private companies for the activities displayed in itens I to IV of the same article, as long as in conformity with the conditions established in Law.

The parameters for creating the new Law which paragraph 1st dealt with were provided in paragraph 2nd of the same article. According to it, the new Law was to guarantee the supply of derivatives of oil in all national territory; provide the conditions of contracting; and determine the structure and attributions of the regulatory agency for the Unions monopoly.

The special rule, which article 177 of the Constitution related to, is Law n. 9478/97 – the Oil Act. This act was responsible for a flexibilization on the monopoly of oil. And although the property of the natural resources on the underground still belong to the Federal Union, the right of exclusivity for exploration that was only granted to Petrobras for more than 40 years was finally opened to other private companies. With the opening of the market for international oil companies, and considering how the Brazilian industry was underdeveloped in relation to that of more developed countries, with more experience in the oil upstream industry, it was deemed necessary the creation of a system that could beneficiate both the exploring companies as well as the country itself. The system adopted was comprised by concession agreements granted after public biddings in upstream activities and authorization for downstream activities.³⁸

Since 2010, due to discoveries made in the pre-salt layer in 2006, a hybrid regulatory system for oil and natural gas exploration and production prevails in Brazil. Law 12351/2010, or the “Pre-Salt Law”, established that the pre-salt areas not yet granted and other strategic areas would operate under a production sharing system. For other areas, representing 98% of the total Brazilian sedimentary basins’ territory, the concession regime, provided by Law 9478/97, is still in force.³⁹

Along with the Pre-Salt Law, the Brazilian Congress approved a new legal framework for operations in the pre-salt area. This process included the creation of Law 12276/2010, regarding the direct granting of areas to Petrobras, by means of an “onerous assignment” of barrels of future oil output as equity contribution by the Federal government and Law

38 Ibid, pp. 420.

39 ANP - Institutional information. Available at: <http://www.anp.gov.br/?pg=70720&m=&t1=&t2=&t3=&t4=&ar=&ps=&cachebust=1412090394780>

12304/2010, authorizing the establishment of a new state-owned company called Empresa Brasileira de Administração de Petróleo e Gás Natural – Pré-Sal Petróleo⁴⁰, or “PPSA”.⁴¹

The scope of this work is analyzing the LC rules in the upstream industry; therefore, there will be a focus on this chapter on the Regulatory Framework for oil exploration in Brazil, which comprises the Oil Act, the Pre-Salt Law along with the Concession Agreements and Production Sharing Agreements.

2.2.2 The Oil Act

Law n. 9478/97, the Oil Act, approved by the National Congress in August 6th, 1997, addresses the national energy policy and implements several other measures. It was edited in accordance with the 9th amendment to the Constitution of 1995, which made the way of execution of the Government monopoly for oil exploration activities more flexible. This Law establishes the conditions for the exercise of economic activities concerned by the Government monopoly, related to the importation and exportation of oil and natural gas, oil refining, natural gas processing and transportation of oil and natural gas and derivatives.

The Oil Act establishes that the activities of exploration, evaluation, development and production of oil and natural gas shall be exercised through concession agreements, granted by public bids. I will relate to concession agreements further on, after relating to government procurement.

As previously mentioned, paragraph 2nd of article 177 of the Federal Constitution describes the parameters to be established in the Oil Act.

The rights of exploration and production of oil, natural gas and other fluid hydrocarbons in the national territory, according to article 21 of the Oil Act, belong to the Union. For this matter, it is irrelevant if the exploration or production takes place in land, in the territorial sea, in the CS or EEZ. This article also states that these rights shall be administered by ANP.

Now, when it comes to the propriety of the oil explored or produced, it is important to note that article 176 of the Federal Constitution makes a differentiation between the terms reservoir, the soil and the already explored oil.

According to article 6, item XI, of the Oil Act, the reservoir is a deposit already identified and ready to start production. Therefore, this must be taken into account when deciding to whom the oil obtained belongs. The reservoir belongs to the Union, which has its monopoly and may either explore it directly or delegate this exploration to particulars through concession agreements following public bids, in accordance with article 23 of the Oil Act.

The particulars have the right of property of the oil obtained, not of the reservoir. Therefore, it could be said that the particulars gain ownership over the oil obtained. However,

40 PPSA: Public company created to manage and fiscalize the oil exploration contracts under the production sharing regime.

41 Recent developments and financing outlooks in the Brazilian upstream oil and gas sector. Sponsored Article for Energy and Infrastructure, Latin America 2013. Published in May, 2013. Pp. 37. Available at: <<http://www.iflr.com/pdfs/08Souza%20Cescon.pdf>>

it still does not correspond to a full ownership, considering that its commercialization is administered through the participation of ANP.⁴²

It is possible to identify in the Brazilian regulatory system some similarities with the Norwegian licensing system. There is the double presence of the State as a regulating agent through ANP, which executes tasks of control and supervision, such as the NPD – Norwegian Petroleum Directorate, and a business function left to Petrobras, which would be similar to the role of Statoil, the Norwegian State oil company, in the 80s. However, the similarities end there. There was not a mandatory participation of Petrobras in joint ventures as it used to be with Statoil in the 1980s.⁴³ However, with the discovery of the pre-salt layer and the adoption of a production-sharing regime for exploration in these basins, the mandatory participation of Petrobras was established in all contracts related to activities of E&P developed in this area. I will relate to these aspects and similarities in a future topic.

2.2.3 Government procurement

As explained, coastal states have sovereignty over natural resources existing in the CS. The contractual model adopted by the national oil sector in different countries has as its main strategic objective to keep the sovereignty over this important natural resource.

Before addressing the issue on the legality under the WTO of the adoption of LC in the oil and gas industry in Brazil, I will provide an explanation of what is government procurement and of the legal framework for this institute in the Brazilian Legal System.

Government procurement is the procurement of goods and services on behalf of a public authority, such as a government agency, and regulations surrounding government procurement. It normally covers all public works, services and supply contracts entered into by a public authority.

Article 175 of the Constitution specifies that the government is responsible for providing public utility services, either directly or under a regime of concession or permission, which must always be done through a public tender.

The Federal Constitution establishes on its article 22, XXVII, that it is under the competence of the Union to create rules concerning general rules of bidding and contracting, in all modalities, with either the direct, local or foundational public administration of the Union, States, Federal District and Municipalities, always taking into account the established in article 37, XXI, and for the public and mixed-capital companies, on the terms of article 173, paragraph 1, III.

Article 37 of the Constitution is regulated by Law n. 8666/93, which establishes general rules on procurement and relevant public contracts for works, services, including adver-

42 Lima, Rayssa Cunha. *Os contratos de concessão da indústria do petróleo e gás natural*. Jus Navigandi, Teresina, year 16, n. 2765, 26 jan. 2011. Available at: <<http://jus.com.br/artigos/18356>>. Accessed in: 6 sept. 2014.

43 Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014, pp. 420.

tising, purchases, sales and leases under the Powers of the Union, States, Federal District and Municipalities.

As established on article 2nd of this Law, when contracting with third parties, the Government shall necessarily determine that these contracts are precedent by a bidding process, except when there is an express provision in Law that admits otherwise.

Since the national oil company of Brasil, Petrobras, is a mixed-capital company, it is relevant to mention that this procedure is also applicable to local authorities, public foundations, public companies, mixed-capital companies and other entities directly or indirectly controlled by the Union, States, Federal District and Municipalities.

Among the objectives of the bidding process is to obtain the most advantageous contract for the public administration, to warranty equal opportunity for all interested parties, and to ensure efficiency and morality in all administrative business. In that way, the Law establishes a series of mechanisms to avoid that the public administrator performs contracts in order to get benefits on behalf of third parties and in detriment of the public goods.

It is worth mentioning that procurement regulations, contracting strategies, vendor pre-qualification, technical standards, bid documents, tender evaluation criteria and contract conditions are instruments of procurement that can be formulated to build national competitiveness through capital investment, technology transfer and skills development.⁴⁴

As mentioned in the introduction, Brazil is a member of the WTO, which implies that it is bound by its rules, among which, the Agreement on TRIM's, that determines treatment no less favorable for foreign products than that accorded to like products of national origin. According to this agreement, LC requirements give preference to national products/services in relation to foreign ones, so its applicability would be illegal.

But again, according to article III: 8(a) of the Agreement on TRIMs, the rules on this agreement shall not be applied to government procurement.

This article imposes three conditions: (i) the measure has to be characterized as 'laws, regulations or requirements governing procurement of products purchased'; (ii) it has to involve 'procurement by governmental agencies' and (iii) the procurement has to be undertaken 'for governmental purposes and not with a view to commercial resale or with a view to use in the production of goods for commercial sale'.

To analyze these conditions, I will refer to the Canada- Renewable Energy decision by the Appellate Body⁴⁵.

For the first condition, the Appellate Body considered that the product purchased by the governmental agencies is electricity, while the products subject to LC were renewable

44 Warner, Michael. *Local Content in Procurement: Creating Local Jobs and Competitive Domestic Industries in Supply Chains*. Greenleaf Publishing. September 2011. Pp. 2.

45 Cf. Canada- Measures Affecting the Renewable Energy Generation Sector Panel Report, WT/DS412/R, WT/DS426/R (19 Dec. 2012). Available at: <http://www.wto.org/english/tratop_e/dispu_e/dispu_e/412_426abr_e.pdf>

energy generation equipment purchased by the generators of such energy. However, by seeing how broad the scope can be, the Appellate Body stated that it “[...] does not intent to extend the report to discrimination relating to inputs and processes of production used in respect of products purchased by way of procurement and rules for determining the origin of products purchased”.⁴⁶ I found it difficult to apply this condition in the oil exploration industry.

The second condition means that the procurement has to be effected “[...] by those entities acting for or on behalf of government in the public realm within the competences that have been conferred on them to discharge governmental functions.”⁴⁷ Following this thinking, the procurement in the oil industry was to be made by ANP itself, for example, and not by the concessionaire. Both contracts are entered into by the companies with public authorities. The concession agreement is entered into by the concessionaire with the Brazilian National Regulatory Agency (ANP) and the production sharing agreement is entered into by the National Oil Company Petrobras or the consortia in which Petrobras is a part of and the Ministry of Mines and Energy (MME). However, although public authorities enter into the contract, the concessionaires themselves perform the procurement.

The third condition is referred to by the Appellate Body as “[...] what is consumed by the government or what is provided by government to recipients in the discharge of its public functions.”⁴⁸ This would sure remove many LC from the derogation of para. 8(a), because only few purchases can fit into this interpretation.⁴⁹

There is a doubt on whether there is a legality of the application of LC rules even if the country is not a party to the GPA, especially after the decision by the Appellate body in the case Canada – Renewable Energy. When addressing this decision, authors Holger Hestermeyer and Laura Nielsen believe that this position may also have an influence in the oil industry.⁵⁰ However, my position is that this decision applies to a case of renewable energy (electricity) and it is not certain that it should by analogy be considered applicable also for LC in the oil industry.

Considering that there still is not a decision on the matter, I will thus use the official position adopted in Brazil that LC in the oil industry represents a measure of government procurement.⁵¹ Since Brazil has not signed the GPA, it remains free to apply LC rules as one of the requirements in order to explore oil and natural gas in Brazil.

46 Ibid, para. 5.63 and n. 500.

47 Ibid, para. 5.61.

48 Ibid, para. 5.68.

49 Hestermeyer, Holger P.; Nielsen, Laura. *The Legality of Local Content Measures under WTO Law*. *Jornal of World Trade*, volume 48, issue 3, 2014, pp. 580.

50 Ibid, pp. 578.

51 As provided by Joyce B. Jacobsen in her master thesis on local content requirements: “Although a founding member of the WTO, Brazil is not a signatory to the WTO Government Procurement Agreement and is therefore not bound by it. Since Brazil has not undertaken to implement rules that forbid restrictions to free trade, the country is free to adopt provisions which give preference to national companies.” Source: Jacobsen, Joyce B., *Local Content Requirements in the Brazilian upstream oil industry*, 2008, pp. 3.

Now, before relating to the concession and production-sharing regimes, it is important to consider the basis of the aspects of the contracting of oil companies. In connection with this, I will analyze the criteria of judgment of offers in the Brazilian system, in which the LC requirements are made.

2.2.3.1 Mechanisms of choice and contracting of oil companies and the criteria of offer in the Brazilian system

In general, there are two possible ways for an oil producer country to select an oil company. The first one is through a tender process. The second is through direct negotiation.⁵²

Around the world, there are three different types of tender processes, which differences can be seen in the criteria used for the judgment of offers: (i) system of discretionary or technical granting; (ii) bidding; (iii) mixed bidding system.⁵³

In the discretionary system, the focus of the host country is to hire the companies with the largest expertise in the activities to be developed as well as the way they perform investments and minimum exploratory works. The financial offer in this case usually does not exist or has a small weight for the criteria offer.⁵⁴

Through the bidding process, the financial offer given for the exploratory basins has a strong weight or is considered as the only judgment criteria. The technical capacity is analyzed for means of qualification, in order to divide the participations in the process.⁵⁵

In the mixed bidding system, the one applied in Brazil, the host country takes into account not only the technical expertise of the oil company, but also its investment intentions and the financial offer given for the basins in question.⁵⁶

In the rounds of bid organized by ANP, the criteria of offer are, in accordance with article 41 of the Oil Act: (i) the minimum exploratory program; (ii) bonus of signature; and (iii) the local content.⁵⁷ Also, the Oil Act establishes in its article 40 that the judgment shall identify the most advantageous proposal based on objective criteria and the principles attributable to government procurement, mentioned previously.

The minimum exploratory program is the work program set forth in the contract and must be mandatorily accomplished by the Concessionaire within the Exploration Phase.

The bonus of signature is the payment made by the company when it signs the exploration contract in order to gain the right to explore a certain basin. The value of such bonus is

52 *Regimes Jurídico-Regulatórios e Contratuais de E&P de Petróleo e Gás*. Edited by Bain & Company e Tozzini Freire Advogados, São Paulo, SP, 2009, pp. 30.

53 Ibid.

54 Ibid.

55 Ibid.

56 Ibid.

57 Ibid.

defined in the tender process, and the winner bidder is the one that offers the higher value, along with the fulfillment of the other criteria.

And finally, local content, the procurement of goods and services from national suppliers.

Although under the concession regime it is only possible to select a company through a tender process, it is possible to directly contract with Petrobras under the production sharing regime, according to article 8 of the Pre-Salt Law. However, this shall only occur in case a consortia is not formed, since Petrobras has a mandatory participation in the exploration of the Pre-Salt basins.

After the judgment of offers, the winning bidder is asked to sign the agreement that will contain the items existent in the proposal presented.

2.2.3.2 Concession Agreements

Concession Agreements in the oil industry can be defined as contracts which grant the right of exploitation of an exploration block by the contracting party ANP to the concessionaire. In case there is a discovery, the concessionaire shall be granted the right of exploration and production of the oil existing in the area. This contract is the basis of rights and obligations of the particular and basis for duties and constraints by the Public Administration. Along with the Oil Act, this Agreement is also a part of the Brazilian oil regulatory framework.⁵⁸

The Law which regulates concessions and permissions for the provision of public services in Brazil is Law No. 8.987/95. However, there was some doubt concerning the applicability of the concession tradition in the Brazilian legal system to the oil sector.⁵⁹ Such doubts were extinguished when the Oil Act stated clearly that the activities dealt in the Act were to be exercised through concession agreements.

Considering the agreements in the oil exploration environment, I would also like to use the definition given by lawyers Maurício Teixeira dos Santos and Rafael Baleroni, of Souza, Cescon, Barrieu e Flesch Law Office⁶⁰:

The Brazilian concession agreement is a tax and royalty agreement, where the concessionaire takes the exploratory risk, is responsible for the exploration and production activities and receives full ownership of the oil produced subject to the financial payment of taxes and royalties, being able to use the oil as it seems best – including exporting.

Law 8987/95 determines rules regarding concession agreements and permission of provision of public services, as established in article 175 of the Federal Constitution. In its

58 Lima, Rayssa Cunha. *Os contratos de concessão da indústria do petróleo e gás natural*. Jus Navigandi, Teresina, year 16, n. 2765, 26 jan. 2011. Available at: <<http://jus.com.br/artigos/18356>>. Accessed in: 6 sept. 2014.

59 Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014, pp. 395.

60 *Recent developments and financing outlooks in the Brazilian upstream oil and gas sector*. Sponsored Article for Energy and Infrastructure, Latin America 2013. Published in May, 2013. Available at: <http://www.iflr.com/pdfs/08Souza%20Cescon.pdf>

article 14, it states that all concessions of public services shall go through a bidding process, following the principles of legality, morality, transparency, equality, the judgment by an objective criteria and adherence to the bid announcement.

During the habilitation process, national and international companies can participate. However, for the signature of the Concession Agreement, it is necessary and mandatory to constitute a Brazilian company with headquarters and administration in the country in order to be characterized as a concessionaire, according to article 68-A of the Oil Act.

The Concession Agreements, according to the established by article 24 of the Oil Act, shall be divided into two phases: exploration and production. The exploration phase must contain the activities of evaluation of a possible discovery of oil or natural gas, for determining its commerciality. The production phase shall include the activities of development.

According to the Oil Act, the Concession agreements shall define, among other obligations, the compromise with acquisition of goods and services of national suppliers (LC).

Concerning the hiring of local personnel, when compared to the Norwegian system, there is not an obligation of the concessionaire to train Brazilian workers, although it is mandatory to hire a certain percentage of local professionals. This can be observed, for example, in clause 19.1 of the concession agreement for the 11th round of bid, which took place in 2013. It stated that the Concessionaire is responsible to hire all labor required for the execution of operations on his own expense and risk, respecting the requirements on LC.

2.2.3.3 *The Pre-Salt Law and Production Sharing Agreements*

With the discoveries made in the Santos Basin in 2006, it was found that the reserves in the pre-salt layer were even larger than expected. Since then, there were many discussions on whether the existing concession model would be able to satisfy the expectations concerning the pre-salt or if it would be better to adopt a new contractual model.⁶¹

Considering this doubts, the production-sharing regime was conceived based on two principles: the low exploratory risk and the existence of large oil reserves in the pre-salt area.⁶²

Law n. 12351/2010, the Pre-Salt Law, was created to regulate the exploration and production of oil, natural gas and other fluid hydrocarbons in the areas of pre-salt areas not yet granted under the Oil Act.

Under a production sharing regime, the Brazilian State and a contracted joint venture will share the oil and natural gas extracted from the area. The costs of exploration, development and production (cost in oil) and royalties are discounted from the total oil produced. The

61 Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014, pp. 485.

62 Ibid, pp. 486.

surplus oil is shared between the Brazilian State and the contracted company or consortium in percentages defined in each contract.⁶³

The main characteristic of this type of agreement is the participation of the State, either directly or through the National Oil Company (NOC). The solution found by the Brazilian government was to establish in Law that Petrobras, the Brazilian NOC, would be the operator of all the blocks contracted under a production sharing agreement. It was also established that a new public company would be created to manage the contracts.⁶⁴ In accordance with article 10, III, 'c', of the Pre-salt Law, the minimum participation of Petrobras in each contract should be of 30% and all the NOC must also bear all the costs and investments made.⁶⁵

This model was first adopted in Indonesia in 1960 and until nowadays is used as a model in several production countries, such as Angola, China and Egypt. By making the NOC a mandatory part of the enterprises, there is a share in the management of the activities of oil exploration and production, in order to acquire know-how from the international companies and so as to allow the exploration of reserves to eventually be transferred to the NOC. This way, the State will not be paid in royalties and taxes. It will instead be paid in oil, which will belong to the State. The State, on its part, will hand a part of the oil produced to the company, as payment for the activities and for the risk taken for exploration and production.⁶⁶

Thus, in general, the main differences with the concession regime are that the resource obtained belong to the State and that the State participate directly in the E&P activities, usually through its NOC, which may or may not be the operator. Also, the State receives a part of the production defined in the PSA, not necessarily being paid by the international oil companies through royalties and taxes.⁶⁷

With the creation of the Pre-Salt Law, article 2nd (X) of the Oil Act suffered a slight modification, in order to add that it is the attribution of the CNPE to increase the minimum LC requirements in production sharing agreements as well as in concession agreements.

According to article 10 (III), 'e', of the Pre-Salt Law, it is the attribution of the MME to propose to the CNPE the technical and economical parameters for the production sharing agreements when it concerns the minimum LC requirements, as well as other criteria related to the development of the national industry.

In article 15 (VIII) of the same Law, the minimum LC requirements are also listed as one of requirements existing in the Bidding Terms. So the oil companies who wish to explore

63 Institutional information by ANP – available at: <http://www.anp.gov.br/?pg=70720&m=&t1=&t2=&t3=&t4=&ar=&ps=&cachebust=1412090394780>

64 Regimes Jurídico-Regulatórios e Contratuais de E&P de Petróleo e Gás. Edited by Bain & Company e Tozzini Freire Advogados, São Paulo, SP, 2009, pp. 22; Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014, pp. 488.

65 Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014, pp. 492.

66 Ibid, pp. 489.

67 Regimes Jurídico-Regulatórios e Contratuais de E&P de Petróleo e Gás. Edited by Bain & Company e Tozzini Freire Advogados, São Paulo, SP, 2009, pp. 23

oil in the pre-salt area need to comply with the minimum percentages in order to participate in the Bidding Process.

The first production sharing agreement was signed in 2nd December 2013 and according to the contract draft, LC is also going to be applied. In addition to the clause on local content (clause 25) it is established in clause 7 that the Concessionaire is to invest in development and research for improvement of the national suppliers in the oil industry.

3 Local Content rules and the relation with competent bodies behind them

3.1 Petróleo Brasileiro S.A. - Petrobras and the role of national oil companies (NOCs) in the implementation of local content

Considering the corporate structure of the Brazilian NOC Petrobras, it is a mixed-capital company, controlled by the Union. Such control is exercised through the property and attainment of at least 50% plus one share of the capital stock of the company. The company is ruled by Law n. 6404/76, the Brazilian Corporate Law and by its Bylaws.⁶⁸

Petrobras was created in 1953, when there was no oil industry in Brazil and the country was not perceived as prospective, the costs for exploration being much higher in the country than in other oil provinces. And since the laws existing at the time forbid the exploration by foreigner companies, Petrobras had no choice but to develop the industry from scratch.⁶⁹

The opening of the oil and gas exploration to companies others than Petrobras allowed Brazil to accelerate the exploration and development of its petroleum resources. At the same time, the country kept a firm control of the sector through regulation and the direct participation of the NOC. The company's extensive knowledge of and operating experience in Brazil's petroleum basins allows it to remain the largest individual holder of concessions and to maintain a majority interest in most other concessions.⁷⁰

Although there is not a mandatory participation of Petrobras in the exploration of basins under the Concession regime, it is established in article 42 of the Oil act that in case of a tie in the tender process, Petrobras shall be the one chosen, in case it is not in a consortia with other companies.

In this sense, by means of comparison with the Norwegian system, the role played by the NOC in the Concession regime in the Brazilian system is different than the one played by Statoil in the Norwegian system in the first rounds. Until the 1985-reform, Statoil held 50% of participation in all rounds of bid, which made the tender process very competitive to other companies who wished to explore oil in the Norwegian coast. This was extremely important for the transferring of knowledge and technology to the Norwegian industry, since one of the criteria used for choosing the winning bidders was the amount of LC to be invested. I will return to this in a further topic.

Along the company's history, the Brazilian government did not impose specific targets or interfere with Petrobras' strategic and operating decisions, even when they generated less revenue for the government. The country prioritized energy security over backward linkages.⁷¹

68 Information available at www.petrobras.com.br/en.

69 Tordo, Silvana. *National Oil Companies and value creation*/ Silvana Tordo with Brandon S. Tracy and Noora Arfaa. World Bank Working Paper no. 218, 2011, pp. 89.

70 Ibid, pp. 116.

71 Ibid, pp. 89.

However, although the company does not have to enforce its government's local content policies, since this is the task of the regulator ANP, Petrobras adopts it as its own operating strategy.

Under the production-sharing regime, it was established in article 10, III, c of the Pre-Salt Law that Petrobras is the operator for all the exploration blocks, with a minimum participation of 30% in the consortia. As an operator, it is responsible for the conduct and direct or indirect execution of all activities of exploration, appraisal, development, production and decommissioning of facilities for exploration and production. This makes it possible for Petrobras to acquire know-how by developing activities in cooperation with international companies.

3.2 Conselho Nacional de Política Energética

One of the accomplishments of the Oil Act was the creation of the National Energy Policy Council (CNPE) as the advisory body of the Presidency for the formulation of energy politics and framework, linked to the Ministry of Mines and Energy (MME).

Among its attributions it was established that it would be responsible for inducing the increase of minimum levels of LC of goods and services to be followed in procurement and concession contracts as well as production sharing agreements.

According to the Oil Act, CNPE was to be regulated through a decree by the Presidency of the Republic. In June 2000, the Brazilian president approved decree 3520, which provided CNPE's structure and the way it was to function. According to it, CNPE is presided by the MME.

Law No. 12.351 of 2010, which deals with the Pre-salt, was responsible for some additions as well as modifications in the attributions of the CNPE. Additions can be observed in the Oil Act, which states that this body is also responsible for defining the blocks which shall be object of Concession or Production Sharing Agreements and provide the increase of the minimum levels of LC of goods and services, not only in Concession Agreements, but also Production Sharing agreements.

Actually, with the modifications in the regulatory regime due to the pre-salt, the position exercised by CNPE was strengthened. It was established that all its proposals were to be submitted to the Presidency of the Republic, what enforces the political character of this body. Among its attributions regarding the pre-salt, it was determined that the CNPE should propose to the President: (i) the rhythm of contracting under the production-sharing regime, taking into account the energy politics as well as the development and capacity of the industry for supply of goods and services; (ii) the exploration blocks which shall be destined to direct con-

tracting with Petrobras under a production-sharing regime; and (iii) the blocks which shall be object of a tender for the contracting under a production sharing regime.⁷²

As for alterations, CNPE role was modified by Law 12.490/ 2011, establishing that it was responsible for defining the strategy and the economic and technological development policy for oil, natural gas, fluid hydrocarbons and biofuels industries, as well as its supply chain.

3.3 Agência Nacional do Petróleo, Gás Natural e Biocombustíveis

In the 90's, Brazil disentangled itself from the direct exercise of economic activities to assume a position of regulator and inspector of the market members. Before that, it acted directly in some activities considered strategic.⁷³

For that reason, specific bodies were created to exercise roles intended for the sectors by them regulated. This 'regulation' was characterized by three powers: (i) to create rules to be applied to that sector; (ii) to ensure its application and (iii) to suppress eventual non-compliances.⁷⁴ These bodies have as main characteristic their organic and functional autonomy in relation to the State and its normative power. Since the State does not have the capacity to follow the dynamism needed in certain sectors, the creation of the regulatory bodies represents a way of accelerating the creation of norms in these areas, especially considering the technical expertise these bodies possess.⁷⁵

The National Agency for Oil, Natural Gas and Biofuels (ANP), body responsible for the regulation, contracting and inspection of economic activities related to the oil industry, was created by the Oil Act, under article 7th. Among its attributions, there is the obligation to elaborate the Final Tender protocols and to promote the rounds of bids for the concession of rights to the exercise of activities of oil and natural gas exploration, evaluation, development and production. It is also responsible for concluding contracts that further arise and for inspecting its correct execution.

Although created by the Oil Act, ANP was only effectively organized by decree n. 2455/98. This decree provided the hierarchic structure of ANP and provided how the tasks of other administrative bodies could be exercised.

From 1999 to 2008 ANP performed 10 Rounds of Bid, which can be divided in two groups. The first group corresponds to the first four rounds. Then, ANP was responsible for conducting all the bidding processes, from the definition of exploratory blocks to the signature of concession contracts. In the second group, which corresponds to rounds 6 to 10, there

72 Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014, pp. 520.

73 Ibid, pp. 410.

74 Aragão, Alexandre Santos de. *As Concessões e Autorizações Petrolíferas e o Poder Normativo da ANP*. In: Souto, Marcos Juruena Villela (coordinator). *Direito e Concessões*. Revista de Direito da APERJ, Rio de Janeiro, v.9, pp. 33-63, 2002, p. 52.

75 Ibid, pp. 54,55.

was a different procedure. In these rounds, ANP had to wait for CNPE's decisions concerning the politics of oil and gas production, as well as for the guidelines for how the bidding processes were to take place.⁷⁶

As for the role of ANP after the edition of the Pre-Salt Law, it was determined that it is responsible for editing and defining the Bidding official invitation as well as the contract to be adopted, in accordance with article 11, items II and III. However, it should be bound by the rules imposed by the CNPE as well as by the MME, which shall sign the contracts, according to article 8.

In order to make sure that the LC policy achieves its main objectives, it is the duty of ANP to make sure that the commitments with percentages of LC are met. But in order for these percentages to be met, it is necessary that the country can provide the companies with all the LC demands.

ANP is criticized when it adopts the standard procedure of believing that the Concessionaire is obliged to make an effort to reach such percentages, to build in the country what is necessary to fulfill the promised offer, even though ANP knows that there are not availabilities and that the development of new suppliers takes too much time and demands large investments.⁷⁷

3.4 The Local Content policy

Since the elaboration of the first concession agreement by ANP, it has suffered many modifications throughout the Rounds, as a form of congregate differences of interest and understanding of several participants in the industry and in ANP itself. The contracts drafts were revised by several bodies in the industry, as well as by the Brazilian Institute of Oil, Natural Gas and Biofuels (IBP)⁷⁸ and independent oil companies, along with ANP. This is done in order to help the industry mature and become stable, by reaching the expectations not only of the country, but also of foreign investors.⁷⁹

In order to improve the participation of Brazilian suppliers in the oil and gas industry, the LC was stipulated as one of the criteria for the judgment of offers during the bid process of the First Round of Bids, which was held on the 15th and 16th June, 1999. It was to be applied in the phases of exploration and production of oil and gas. It's relevance on the calculation of the offer as well as the limits of percentage offered during the bids have varied significantly since then.

⁷⁶ Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014, pp. 520.

⁷⁷ Ibid, pp. 464.

⁷⁸ IBP is a private non-profitable organization, founded on November 21, 1957, with over 200 companies as members. It has as main focus the development of the national oil, gas and biofuels industry, so as to make it more competitive, sustainable, ethical and socially responsible.

⁷⁹ Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014, pp. 460.

In the concession agreements, the LC requirement is applied in clause 20, which in summary requires operators to purchase a certain percentage of goods and services from locally established providers. Concessionaires are required to hire Brazilian suppliers when they offer conditions of price, term and quality more favourable or equivalent to those offered by foreign competitors.

ANP has made use of local content requirements in the oil and gas field since 1999. However, only in 2003, for the 5th Round, it began establishing a minimum percentage of products and services acquired locally. The biggest innovation happened in the 7th round⁸⁰, with three main changes: the demand that percentages proposed by the bidders were to be situated within minimum and maximum values; the publication of the Booklet of Local Content, used for the measuring of contractual LC; and the prescription of criteria for the process of certification of LC, provided by the supplier market.⁸¹ Also, there was a differentiation in the Final Tender Protocol between the areas to be offered on the 7th Round in part A and part B. The bid of blocks with exploratory risks had specific conditions in part A of the Final Tender Protocol.

Although the LC did not have its origin in formal Law⁸², it is based, since 2005, in a Local Content Booklet, applied since the 7th round. It contains rules that must be observed by the Concessionaire, the party who has a direct, immediate and contractual relationship with ANP, but, at the same time, tries to create contractual links to make the compliance by third parties (the suppliers) possible.⁸³

The Local Content Booklet is a document which contains definitions, methods and criteria for calculating LC, considering that since 2007 it was mandatory for the companies to prove the purchase of goods and services acquired locally through a certificate. It aims to identify the origin of the components produced, correspondent to the parts of each equipment; considers the value of imported inputs in comparison to the value of the national inputs and consolidate them in the LC Index.⁸⁴

Even though this Booklet made the method of LC clearer, there are still critics concerning its efficiency. There are also several critics to the whole proceeding involving the LC application. The general agreement is that such proceeding is not considered practical.⁸⁵ In order to calculate the percentages of LC, there are many items, sub items, spreadsheets and

80 Information available at: <http://www.anp.gov.br/brasil-rounds/round7/english/index.asp>

81 Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014, pp. 462.

82 In the Oil Act, it was established that the CNPE was to induce the increase in the local content requirement, but did not provide a concept or any other information regarding the measure.

83 Quintans, Luiz Cesar P. *Ensaio Crítico sobre a Natureza do Conteúdo Local Brasileiro: Imperfeições no Fomento à Indústria Local*. Revista Brasileira de Direito do Petróleo, Gás e Energia. 3rd Volume, 2012.

84 This Booklet can be found attached to the new ANP's Resolution n. 19 of June 2013.

85 Quintans, Luiz Cesar Pazos. *Direito do Petróleo – Conteúdo Local: A Evolução do Modelo de Contrato e o Conteúdo Local nas atividades de E&P no Brasil*. Rio de Janeiro, Freitas Bastos Editora: 2009.

big programs to be filled out. This cannot be characterized as an objective criteria, one of the requirements held by the Oil Act, article 40.⁸⁶

In addition to the LC Booklet, there are four Resolutions which were all edited by ANP on 13th November, 2007: (i) Resolution n. 36 defines the criteria and procedures for the execution of activities of LC certification; (ii) Resolution n. 37 defines criteria as well as procedures for the registration and accreditation of entities for the exercising of LC certification activities; (iii) Resolution n. 38 establishes the criteria and procedures for audit in certifying companies for LC of goods and services; and, finally, (iv) Resolution n. 39, defines reports of local investments in exploration and development of production in Concession Contracts, from the 7th Round of Bids.

These Resolutions are based on the fact that the acquisition of goods and services by local suppliers must be proven to ANP, through the presenting of LC certificates. Also, the concessionaires must demand that the suppliers present certificates for their products. The activities related to certification shall be executed by duly qualified agencies, accredited by ANP, on the basis of pre-established criteria developed by it.

There was a great discrepancy between the legal aspects of the demand for certification and the capacity of the companies for the exercise of this function. Also, even ANP needed a reasonable deadline for the organization and training of a qualified team to provide information regarding the topic to the market in general.⁸⁷

In order to clarify matters which were subject to discussions as well as to change certain LC requirements, on June 2013 new rules on LC were provided by Resolution ANP 19, revoking Resolution ANP 36. This new resolution also contains two attachments: the Local Content Booklet and the model local content certificate (Model Certificate).⁸⁸

Among other things, this new Resolution provides a mandatory certification criteria for all items that fall in the definition of goods. Before that, only items with a Mercosur Common Nomenclature (MCN)⁸⁹ higher than 83 had to be certified. In addition to that, all good must be individually certified, even if they integrate other goods, sets or systems.⁹⁰

86 Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014, pp. 464.

87 Ribeiro, Marilda Rosado de Sá. *Direito do Petróleo*. 3rd edition, Rio de Janeiro, Renovar, 2014, pp. 464.

88 Davila, Daniela; Arruda, Patricia; Pires, Flavia. *New Rules on Brazilian Local Content*. Vieira Rezende Advogados Associados. Oil & Gas Bulletin, July 2013. Available at: http://www.vrbg.com.br/site/arquivos/Newsletter_O%26G_Jul_13_en.pdf

89 Term adopted by the countries that integrate the block - Argentina, Brazil, Paraguay, Uruguay and Venezuela - to foster international trade growth, make the creation and comparison of statistics easier, in addition to elaborating freight tariffs and providing other relevant information to international trade. The measure to calculate MCN is provided by the Local Content Booklet.

90 Davila, Daniela; Arruda, Patricia; Pires, Flavia. *New Rules on Brazilian Local Content*. Vieira Rezende Advogados Associados. Oil & Gas Bulletin, July 2013. Available at: http://www.vrbg.com.br/site/arquivos/Newsletter_O%26G_Jul_13_en.pdf

Something was done also concerning the dilemma on whether imported products could also be certified for LC. Now they can as long as they are subject to REPETRO⁹¹.⁹²

It was established also that payments of fees due to governmental entities, trade unions and governmental agencies shall not be subject to certification. The same is applicable for pilotage services and compensation for the use of land.⁹³

Finally, there is evidence that Resolution ANP 37 will also be revised in the future, in order to make the application of LC requirements even clearer.⁹⁴

Now, relating to the judgment of offers in the bidding rounds, the winning bidder is asked to sign the agreement that will contain the items existent in the proposal presented. Upon award of the concession, the LC requirement is included in the concession agreement and thus becomes a contractual obligation of the concessionaire. This means that in case the concessionaire does not comply with the percentages presented in the proposal, there is a breach of contract.

ANP monitors compliance and, in case there is a breach in the duty to comply with the LC requirements, the concessionaire will be subject to the penalties expressed in the contract, as well as in ANP's decree n. 243/03, in proportion to the amount of the non-compliance.

The observation of non-compliance shall be done at the end of the exploration phase or at any time during the development phase. This is so because since the total duration of the contracts is of 36 years⁹⁵, it would not be reasonable to wait until the end of the contractual period to analyze whether there was compliance or not.

Therefore, every three months the concessionaires are obliged to present a report with expenses, in order to prove the compliance of percentages, in accordance with ANP's Decree n. 180/2003.

Some improvements have been made concerning the non-compliance penalties, which can be observed in the concession agreement for the 11th round when it comes to exemptions from the compliance with the LC, in case (i) there is no Brazilian supplier for the product or service required; (ii) proposals received by Brazilian suppliers present excessive delivery limit in relation to non-Brazilian suppliers; (iii) proposals received from Brazilian suppliers present an excessive price in relation to non-Brazilian suppliers; and (iv) the technology required cannot be replaced by a product with LC.

91 Special customs regime that allows the importation of specific equipment to be used directly in the exploration and exploitation of petroleum and natural gas, without the incidence of federal taxes, plus additional freight for renewal of merchant marine.

92 Davila, Daniela; Arruda, Patricia; Pires, Flavia. *New Rules on Brazilian Local Content*. Vieira Rezende Advogados Associados. Oil & Gas Bulletin, July 2013. Available at: http://www.vrbg.com.br/site/arquivos/Newsletter_O%26G_Jul_13_en.pdf

93 Ibid.

94 Ibid.

95 Ibid, pp. 460.

In this sense, the burden is no longer put on Concessionaire in case there is a lack of goods or lack of capacity by the Brazilian suppliers to provide them.

So far, 11 bidding rounds have taken place since 1999. The last one was held in May 2013 and the average LC was of 62% for the exploratory phase and 76% for the development and production phase.

As mentioned, the first production sharing agreement was signed in 2nd December 2013 and LC is also being applied.

3.5 Programa de Mobilização da Indústria do Petróleo e Gás Natural

Due to the implementation of the LC policy in the oil and gas sector in Brazil, the Brazilian government created the Mobilization Program for the National Industry of Oil and Gas (Pronimp), under Decree no. 4925/2003.⁹⁶

The program, coordinated by the MME as well as by Petrobras, makes it possible for several participants in this industry to have a permanent discussion forum for the development of actions that improve, in a competitive and sustainable way, the participation of the national suppliers of goods and services to implant their oil and gas products in Brazil as well as abroad.⁹⁷

Thanks to this program, the shipping industry was resumed, with Petrobras emerging as major global shipbuilding offshore buyer. Demands made for the Brazilian shipyards increased significantly, both by investments in new plants, as for expansions and upgrades of existing facilities. Besides generating employment, the development of the maritime sector has brought a positive outlook for its entire supplier chain by encouraging the generation of new technologies.⁹⁸

It has been noticed that these programs have helped to promote the capacity of national suppliers and bring foreigner companies to produce in Brazil part of what used to be produced in foreign countries improving the countries competitiveness in the national supply market.⁹⁹

The plan now is that until 2020 38 platforms, 28 drill rigs, 146 support vessels and 88 large vessels will be built. In addition to that, there is also a project to build 4 new refineries to improve the country's refining capacity. All of these projects will be developed following the LC requirements strategy, which will generate opportunities to the whole national production chain.¹⁰⁰

96 Programa de Mobilização da Indústria Nacional de Óleo e Gás Natural. Available at: http://www.prominp.com.br/prominp/pt_br/conteudo/sobre-o-prominp.htm

97 Ibid.

98 Ibid.

99 Ibid.

100 Ibid.

4 The Norwegian System and similarities

4.1 The upstream regulatory framework

The Norwegian regulatory regime functions through a licensing system, under the rules of the Petroleum Act (PA) – Act 29 November 1996 no. 72. The resource manager is the King and the executive powers rest with the Cabinet, which delegate its powers to the Ministries. The Ministries, on their part, delegate authorities to the subordinate Directorates. In practice, the resource manager acts as a licensing and regulatory authority.¹⁰¹

The licensing system in Norway started with the 1965-Decree¹⁰², passed pursuant to the 1963-Act section 3 in connection with the first license round. Due to discoveries made in 1969 in the Ekofisk field, the government stipulated tougher license terms under the 1972-Decree¹⁰³. After the discovery of several oil fields, the Norwegian Parliament passed a petroleum act in 1985¹⁰⁴, which represented a “continuation of the license system and a codification of governmental practice under this system”¹⁰⁵. Finally, the 1985-Act was replaced by the new petroleum act in 1996, the PA, when Norway had already become a party to the EEA.

When the first licenses were granted in 1965, Norway did not possess much negotiating power with regard to the oil companies. However, in the early 70s, many large international oil companies were excluded from the petroleum regions in the world, the oil price rose¹⁰⁶, and Norway became more promising as a petroleum region. With this, there was an increase in the negotiating power of the Norwegian government throughout the 70’s and 80’s. In this sense, the concessionary procedure was used as an instrument to enforce the participation of international oil companies to engage in technology transfer and LC development.¹⁰⁷

4.2 The Local Content requirements

As previously mentioned, it is not exactly correct to say that Norway has never made specific requirements as to the share of LC. It was evident that the Norwegian government and politicians gave preference to the choice of local firms to supply the oil and gas activities with goods and services. It was considered as a ‘best effort’ clause, so to say, different than the Brazilian model where it is applied a fine in case of non-compliance.

This could be observed in the concession agreements before Norway become a member of the EEA. In the agreement for the 8th round, for example, held in 1984, there was a

101 Hammer, Ulf. *The Petroleum Act*. Marlus nr. 404, Nordisk institutt for sjørett, Universitet i Oslo. Sjørettfondet, 2011. Pp. 34.

102 Royal Decree of 9 April 1965 relating to exploration for and exploitation of petroleum.

103 Royal Decree of 8 December 1972 relating to exploration for and exploitation of petroleum.

104 Act no 11 of 22 March 1985 pertaining to petroleum activities.

105 Hammer, Ulf. *The Petroleum Act*. Marlus nr. 404, Nordisk institutt for sjørett, Universitet i Oslo. Sjørettfondet, 2011. Pp. 13.

106 Between October 1973 and February 1974 oil prices were quadrupled after the drastic price increases of the OPEC countries. Source: Krohn, Mads et al. *Norwegian Petroleum Law*, Sjørettsfondet, Scandinavian Institute of Maritime Law, 1978, pp. 2-3.

107 Nordås, Hildegunn Kyvik; Vatne, Eirik ; Heum, Per. *The upstream petroleum industry and local industrial development: a comparative study*, Institute for Research in Economics and Business Administration, Bergen: SNF Report No. 08/2003, pp. 65.

provision in clause VI that stated: “[...] Norwegian suppliers shall be included in all requests and invitations to bid provided they can offer goods and services as required.”

Also according to this clause, Norwegian goods and services were to be chosen if the conditions were considered competitive.

The same could be observed in clause 13th of the concession agreement for the 12th round, held in 1988, which provided that competitive bids were to be given preference unless if that implied in the displacement of a competitive Norwegian supplier.

In the 12th round, there was also a training agreement attached to the concession one, which stated in item 2.1 that a National company could demand that its employees participated in foreign companies courses, seminars and other training programs relevant for petroleum activities. According to item 3.1, the aim of this measure was to develop competence within the local industry.

And finally, also attached to the concession agreement for the 12th round was the Agreement on Technological Research and Development (R&D) concerning petroleum activities. Its purpose was to make use of and develop competence and know-how among Norwegian contractors in order to develop new technology.

Among the operators’ obligations was, according to clause 3.1, to ensure that at least 50% of the total expenditures of R&D covered by the production license would be spent in Norway and in cooperation with Norwegian contractors.

It is thus possible to see that not only LC measures were applied in concession agreements in Norway, but that there were also specific and mandatory requirements, including training of professionals and research, used as forms of LC.

Even when addressing legal literature from the period before Norway had become a part of the EEA, it is possible to see a favorable opinion concerning the preference given for local suppliers in the oil industry. As elegantly provided by Krohn et al.:

It is obvious that there are several Norwegian companies which have been granted special advantages simply because they are Norwegian. I believe for example that a company such as Saga Petroleum would have been considered too weak both financially and technologically if it had, as a non-Norwegian company, applied for a license on the Continental Shelf. This is not in any way meant as a criticism.

Nor have the authorities disguised the fact that one might contemplate such discrimination. The intention has been to assist in the development of a national oil industry i.a. by giving Norwegian companies shares in licenses and other possibilities to build up their expertise in all necessary fields. One has thus made up for the Norwegian companies’ lack of competitive ability, by relaxing the conditions for obtaining license shares, as well by other measures designed to improve their competitive situation.

I cannot see that neither the act giving administration authorities nor principles of equality in administrative law are any hindrance in this respect. In political circles in Norway, it has been rather forcibly

maintained that too little effort has been made to help Norwegian companies enter the oil industry.¹⁰⁸

Although the first round of concessions was the biggest of them all, LC was not yet considered a relevant issue then. Therefore, there are no statistics that show the involvement of national companies or LC in the first phase of drilling in the North Sea.¹⁰⁹

Actually, during this phase, the majority of suppliers used by the exploring companies were Americans. This was also observed in the working labor, which was in their majority workers with experience from the oil sector in the Gulf of Mexico.¹¹⁰ This, however, was seen as an opportunity for Norwegian engineers to see and learn.¹¹¹

Even though the companies also hired Norwegian workers, it was basically to satisfy the Norwegian authorities, and such labor force was poorly paid in comparison to American professionals, as well as cheaper to employ.¹¹²

These facts only enforced the need of measures to ensure that the Norwegian working force could benefit from the oil activities developed in its own country, by getting a good qualification and being able to pass it on to others.

Actually, there was a fear that foreign engineers working for oil companies as well as companies specialized in engineering would prefer foreign suppliers, not because these were better or cheaper, but because their work was already known. The foreign suppliers would always enter into a tender process with some advantage. Therefore, it was clear that some protectionist measure was necessary to end the disadvantage of the Norwegian industry. This is one of the reasons for why it was provided in section 54 of the PA of 1972, which equals to section 48 of the PA of 1985, that the licensee had to be based in Norway in order to be able to organize and perform its activities.

Article 54 of the ministerial ordinance of 1972 and the following Oil Act of 1985 attracted attention in the political discussions regarding protectionism. However, the most effective measure to increase the Norwegian participation was the negotiating power of the State concerning the allocation of concessions and permissions for development, as well as the capacity of the State-owned Statoil to affect the contract distribution.¹¹³ The degree of protectionism existent in article 54 was, in the end, dependent of interpretation.¹¹⁴

108 Krohn, Mads et al. *Norwegian Petroleum Law*, Sjørettsfondet, Scandinavian Institute of Maritime Law, 1978, pp. 2-48, 3.331.

109 Ryggvik, Helge. *Building a Skilled National Offshore Oil Industry – The Norwegian Experience*. NHO, Avdeling for internasjonalisering og europapolitikk, 2013, pp. 18-19.

110 Ibid, pp. 19.

111 Ibid, pp. 21.

112 Ibid, pp. 19.

113 Ibid, pp. 195.

114 Ibid, pp. 50.

Despite the insistence of the Ministry of the Industry that article 54 was not protectionist, all the parties involved knew that if the government really wanted to apply it, it would make an opening to force the operators improve its acquisitions of local goods and services.¹¹⁵

The Norwegian naval sector, on its part, was against the use of article 54, for considering that it would be an immediate hinder to the successful advancements in the market of semi-submersibles drilling rigs. The Norwegian shipowners were afraid that a protectionist measure could fail and that the British could stop buying their drilling rigs. Their opposition was so strong that the Ministry of Industry affirmed that support vessels and drilling rigs would be exempt of complying with article 54, which did not completely satisfy the shipowners. For that reason, this article was inactive in its first year of existence.¹¹⁶

In 1974 though, a crisis started affecting the Norwegian naval construction sector. Because of that, many shipyards began to support a more protectionist position on the part of the government. This year was decisive for the opening to a more protectionist industry in Norway.¹¹⁷

Specific requirements were made in domestic capacity building concerning the domestically based oil companies, Statoil and Norsk Hydro, and also Saga Petroleum, which later was merged with Norsk Hydro. In the beginning, these companies did not possess the expertise necessary to be fully operating oil companies. Therefore it was established that they would be operators in the production licenses, while foreign companies would volunteer to become technical assistants, and by doing so, they would contribute with the necessary technology transfer. Technology transfer also took place through agreements with foreign oil companies to locate research and development to Norway and to have research cooperation with universities and research institutes in Norway.¹¹⁸

As a part of the tender process, Norwegian authorities required that the operator presented the firms on its bidders list for the Ministry before the tender, and it was also possible for the Ministry to add Norwegian based firms on the list. In that way, local firms were not excluded for not having previous experience as a part of the supply chain of the foreign oil companies. The Ministry also had the power of change in the decision concerning the choice of firm to the contract. Therefore it was established that the Ministry was to be informed of which firm had been chosen. However, this happened only once.¹¹⁹

115 Ibid, pp. 51.

116 Ibid, pp. 51-52.

117 Ibid, pp. 52.

118 Nordås, Hildegunn Kyvik; Vatne, Eirik ; Heum, Per. *The upstream petroleum industry and local industrial development: a comparative study*, Institute for Research in Economics and Business Administration, Bergen: SNF Report No. 08/2003, p. 65.

119 Ibid, pp. 66.

4.3 NPD

Concerning the political documents related to the oil produced existing at the time, two of them were fundamental to lead the general orientation of the Norwegian petroleum politics. The first one, created in 1971 by the industrial committee of the parliament, also called as the “10 commandments”, listed ten points in order to ensure that the natural resources in the Norwegian continental shelf were explored in a way that it could benefit the whole society. Some of these “commandments” were said to state the obvious. However, the expression “governance and national control”, present in the first point, represented the basis for development of the Norwegian oil industry.¹²⁰

Following this principle, the second document, also created by the Parliament in 1972, lead to the creation of the Norwegian Petroleum Directorate – NPD. This body was to be the competent body of the State for the administration of resources, being also responsible for regulating the working environment as well as for safety issues.¹²¹

4.4 Statoil

Statoil was established in 1972 and was meant to be a vehicle of the Norwegian State. It a 100% State owned Oil Company¹²², and was granted 50% participating interest in all licence groups from the third licence round. It also had privileges in the joint operating agreements and a dominant position in the decision making process.

Statoil could affect the contracts either between licensee groups, which had big shareholder participations, or later, as an operator. With the demand that all companies had an obligation to perform at least 50% of relevant research in Norway and the with the so-called technology contracts, protectionist measures contributed even more to support the development of research groups specialized in oil in the country.¹²³

As mentioned before, the LC rule was considered as a “best effort clause”. Since Statoil had 50% participation in all rounds, the other companies had to compete hard to be able to get a participation in the other 50%.

However, although Statoil has actively contributed to support Norwegian companies, until the 1980s it aimed to ensure that there was a sufficient number of suppliers side by side, in order to keep the element of competition.¹²⁴

120 Ryggvik, Helge. *Building a Skilled National Offshore Oil Industry – The Norwegian Experience*. NHO, Avdeling for internasjonalisering og europapolitikk, 2013.

121 Ibid.

122 Nordås, Hildegunn Kyvik; Vatne, Eirik ; Heum, Per. *The upstream petroleum industry and local industrial development: a comparative study*, Institute for Research in Economics and Business Administration, Bergen: SNF Report No. 08/2003, pp. 63.

123 Ryggvik, Helge. *Building a Skilled National Offshore Oil Industry – The Norwegian Experience*. NHO, Avdeling for internasjonalisering og europapolitikk, 2013, pp. 196.

124 Ibid, pp. 196.

Local content participation in Norway ranged from favoring Statoil in licensing rounds, by thus increasing the chances of developing local suppliers, to encouraging the use of goods and services produced locally and leveraging the country's expertise in shipbuilding and marine services.¹²⁵

Statoil's responsibilities concerning its role as an instrument for LC development gradually disappeared over the previous 30 years.¹²⁶

With the 1985-reform, Statoil's participating interest was split into Statoil economic share and State economic share (State Direct Financial Interest – SDFI). Statoil was responsible for managing the SDFI in the licence groups on behalf of the State. Its dominant position was considerably reduced due to change of voting rules in the joint operating agreements.¹²⁷

With the 15th license round and the implementation of the licensing directive 94/22/EC, Statoil loses privileges and must be treated as a normal commercial entity.¹²⁸

After the 2001 reform, Statoil was no longer a vehicle for the Norwegian State. It was partly privatized and introduced on the stock exchange, although the State continued as the majority owner. Statoil cannot manage SDFI anymore because it's partly privatized.¹²⁹

125 Tordo, Silvana. *National Oil Companies and value creation*/ Silvana Tordo with Brandon S. Tracy and Noora Arfaa. World Bank Working Paper no. 218, 2011, pp. 116.

126 Ibid, pp. 116.

127 Hammer, Ulf. *The Petroleum Act*. Marlus nr. 404, Nordisk institutt for sjørett, Universitet i Oslo. Sjørettfondet, 2011. Pp. 22.

128 Ibid, pp. 23.

129 Ibid, pp. 23.

5 Conclusion

In this paper I provided the reader with the regulatory aspects of the Brazilian legal system concerning oil exploration. My intention was to show not only the legal background but also how each institution worked and how their responsibilities were applied when it concerned the application of LC in the Brazilian oil industry.

Although still not the ideal model, receiving many critics due to its complicated rules and procedures, many improvements have been seen along the different rounds concerning the LC requirements, since when ANP started applying them in the concession agreements in 1999.

I made also a comparison between the Brazilian legal system and the Norwegian when concerning the regulatory aspects in the upstream industry and the application of LC requirements. My objective was to point out the successful experience of a developed country that used such measures in the oil industry in the past. Norway is one of the examples that show how efficient the LC measures are not only for the development of the industry, but also for training of local professionals.

The Norwegian industry applied LC as a ‘best effort’ clause, so that companies would need to do their best in order to be picked up in the tender process to explore oil in the NCS. In Brazil LC is a contractual obligation. A non-compliance fine is applied if the percentages of LC agreed during the tender process and in the contract are not met. This difference might be justified by the different contexts in which each country performed and still perform its activities.

When Norway started exploring oil in the 70s, the international political and economic framework was favorable for Norway to have an increase in its negotiating power. Oil prices were high and big oil companies saw in Norway a promising country for doing business.

Brazil however only opened its market for other oil companies in 1997, period when the biggest oil exploring countries already had a developed industry and thus, did not need to apply LC anymore. Foreign companies which aim to explore oil in Brazil thus already have the knowledge and expertise necessary to perform the exploration activities. Not only that, they also have access or know how to get access to the best materials, for the lower prices in other countries. Therefore, they hardly would give preference to goods or services provided by local suppliers unless some measures were taken for these actions to take place.

Therefore, after deeply researching in order to write this thesis, I find myself in favor of application of LC in the oil upstream industry in Brazil, although I also think there is still a need for improvement. There might not be a receipt for success, but some aspects may be taken into consideration.

Many countries have a weak and narrow industrial base. For this reason, LC policies contain measures that allow for the preferential treatment of domestic companies. To ensure

sustainable industrial growth, however, such preferences should be temporary.¹³⁰ As already said, they should be applied until the country can ‘walk with its own legs’, with a developed and competitive industry.

Another aspect that must be considered is that the adoption of increasing levels of LC may discourage investments in the sector, especially if the Brazilian industry cannot comply with the demand made by oil companies with competitive deadlines and prices. This measure harms especially national and foreign companies with ample access to foreign technological resources.¹³¹ Therefore I consider that there should be an effort by the several bodies involved with the LC application to make sure the industry can cope with what is expected of them. Otherwise, since the Concessionaires are punished in cases of non-compliance, oil companies might consider the Brazilian industry not so attractive for its investments. In this sense, there were improvements adopted in the 11th round of bid, which exempt Concessionaires of compliance with the established LC percentage in case the Brazilian suppliers cannot cope with the demand.

As of measures that could be adopted in order to guaranty the correct and efficient application of LC, I take as examples general principles provided by Silvana Tordo¹³²: (i) to set transparent and measurable targets that are within the reach and capability of the country, to avoid unrealistic expectations. Also, companies should be held accountable for missing targets; (ii) policy makers should take into consideration the ability of the rest of the economy to develop service capacity through backward linkages. Assess existing local capacity and manage the pace and scheduling of petroleum’s sector accordingly; (iii) gradually maximize local-value added, by focusing in investing in activities that have the highest potential to add value; (iv) create and enhance the development of skills that can be transferred to other sectors, including the development of skills that are common to all sectors; (v) make periodical reports on the performance of local and foreign companies in order to establish benchmarks and targets as well as to create opportunities for transferring best practice. Such reports must also be made public; (vi) finally, the government should focus on improving local skills, business know-how, technology, capital market development, wealth capture and wealth distribution to create conditions for domestic companies to emerge. This should be done in connection with the fact that the preference given to domestic companies should be temporary so that these have the incentives to be competitive and to develop sustainable industrial growth.

130 Tordo, Silvana. *National Oil Companies and value creation*/ Silvana Tordo with Brandon S. Tracy and Noora Arfaa. World Bank Working Paper no. 218, 2011, pp. 10.

131 Gomes, Carlos Jaques Vieira. *O marco regulatório da prospecção de petróleo no Brasil: o regime de concessão e o contrato de partilha de produção*. Textos para discussão 55, Centro de Estudos da Consultoria do Senado Federal. March, 2009. Available at: <http://www12.senado.gov.br/publicacoes/estudos-legislativos/tipos-de-estudos/textos-para-discussao/td-55-o-marco-regulatorio-da-prospeccao-de-petroleo-no-brasil-o-regime-de-concessao-e-o-contrato-de-partilha-de-producao>

132 Ibid, pp. 10, 11.

Something that I also think may be favorable in the application of LC and should be taken from the Norwegian example is the matter on training of professionals. As shown, one of the LC requirements in the Norwegian industry was the mandatory training of local professionals by foreign companies who wished to explore oil in the country. This is not an obligation of the oil companies in Brazil, and I think it should be in order to benefit not only the country, by qualifying working labor, but also the companies themselves, which will have the necessary working force.

There has recently been though some improvements in the Brazilian management of the LC requirements with the adoption of the production sharing regime for the new pre-salt areas. It is possible to see some similarities with the Norwegian concession regime in the past. Petrobras has a mandatory participation in all production sharing licenses as the operator and foreign companies have the contractual obligation to invest in research. The aim is to ensure the transfer of know-how by the international companies to the NOC.

Along this work, I also took into account the legality of use of LC considering that Brazil is a member of the WTO. The opening of the Brazilian market for oil exploration happened rather late in comparison with other countries, which also led to a late establishment of legal basis for the regulatory regime and for bodies responsible for the ruling and supervision of the application of LC. At this period, Brazil was already a member of the WTO and bound by its rules. However, Brazil did not sign the GPA and is not obliged to follow these rules on government procurement. By saying this, I take into consideration that the LC measures represent a form of government procurement applied in concession agreements and production sharing agreements.

As my personal opinion, when considering that there is a doubt on the legality of the application of LC rules even if the country is not a party to the GPA, I think it is rather unfair that many developed countries had had the opportunity to apply LC measures in their industries in the past, but nowadays demand that developing countries do not apply them due to breach of rules of freedom of trade. Many of those countries could develop their industries due to the preference given on products and services of national origin, as well as demand training of local professionals. I believe that LC measures are a good way to provide the industry with the know-how necessary for it to be able to, in the future, compete with other industries as equals. Only by applying the LC requirements in an efficient way will developing countries be able to properly manage their natural resources and thus lift the resource curse, as so many developed countries had the chance of doing in the past.

This has also been the opinion of some other authors, and I would like to end this thesis with a citation of Rabiú Ado¹³³, which reflects my point of view:

133 Ado, Rabiú. *Local Content Policy and The WTO Rules of Trade-related Investment Measures (TRIMs): the Pros and Cons*. International Journal of Business and Management Studies. Aberdeen: Vol.2(1), 2013, pp.142.

Unfortunately, the policy appeared to be one of the performance requirements said to be in violation of the provisions of GATT and therefore prohibited. Why did this prohibition only come after the policy benefits had long ago been exhausted by many developed countries? This question needs an answer. Is it because their industries have developed enough and do not need protection anymore? This may possibly be the answer. Having realized this facts resource rich developing countries stick to the application of this rule to develop their economies in the way the others had done.

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